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Marketing Your Organization Through Financial Statements - Best Practices for Effective Financial Reporting

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STRENGTH MATTERS® Best Practices in Financial Reporting Webinar Series
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Learning Objectives

- To understand why properly classified assets and liabilities help demonstrate the financial flexibility an organization does or does not have.
- To recognize the manner in which outside parties - especially lenders and funders - will interpret and apply the classification of assets and liabilities in making funding decisions.
- To tie your balance sheet’s story to your liquidity discussion

Financial Statement Issues – Classification of Assets & Liabilities

- Preparation of the Statement of Financial Position (Classification of Assets & Liabilities) – Topic 6

- Cash Presentation – Topic 15

- Accounting for Contributions, Exchange Transactions and Forgivable Loans – Topic 21

Current Assets

Assets that are expected to be realized in cash or sold within one year:

- Accounts Receivable
  - Grants
  - Development Fees
- Prepaid Expenses expected to be incurred within a year
- Notes and Interest receivable to be collected within one year
- Property Held for Sale

What are Cash Equivalents?

- Cash equivalents are investments in financial instruments that have a maturity of 3 months or less

- Investments are financial instruments with maturities of 3 months or more

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How Are Cash & Cash Equivalents Classified?

Classify as a current asset if:

The cash is available to be used or is expected to be used to satisfy current liabilities or to pay for expenses to be incurred within one year.

Corporate:

- Unrestricted Cash & Cash Equivalents
- Restricted Cash to be used within one year as required:
  - under a specified contract,
  - by a donor requirement
  - as designated by the Board of Directors

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Classification of Cash & Cash Equivalents

Classify as a current asset if:

The cash is available to be used or is expected to be used to satisfy current liabilities or to pay for expenses to be incurred within one year.

Property:

- Unrestricted Cash & Cash Equivalents
- Reserves expected to be drawn upon to fund expenses to be incurred within one year
  - Operating Reserves
  - Section 8 Overhang Reserves
  - Income tax & Insurance reserves

Classification of Cash & Cash Equivalents

Classify as a long term asset if:

- Cash is reserved for expenses to be incurred more than one year following the balance sheet date.

Corporate:

- Cash Restricted
  - under a specified contract,
  - by a donor required
  - as designated by the Board of Directors

Property:

- Operating Reserves
- Section 8 Overhang Reserves

Classification of Cash & Cash Equivalents

Classify as a long term asset if:

- Cash is reserved to pay for debt classified as long term – e.g. sinking funds
- Cash is reserved to acquire non-current assets – e.g. Replacement Reserves for Fixed Assets
- Tenant security deposits – even if refunded, quickly replaced with a new deposit
- Cash Equivalent or Cash will be replaced with another long term instrument

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Long Term Assets

Assets that can be expected to be held or realized in cash or sold <u>more than</u> one year from the balance sheet date:

- Deposits held
- Property under development
- Deferred development fees
- Notes & Interest receivable
- Unamortized costs - financing (over term of debt) and tax credit monitoring fees (over the term of the credits

Lender Perspective

- Everyone in your organization needs to recognize that your financial statements are "telling a story" to outside parties.
- First impressions count. Well-annotated financials pave the way to a productive lending relationship.
- A well-organized and informative set of financials reflects a well-governed and well-managed business.
- Financials allow your organization to set the terms of the discussion with lenders by "getting ahead" of issues that are bound to emerge during underwriting.

Lender Perspective - Assets

- Break down current assets.
  - Financials that don't break down current assets are a big red flag.
    - Sends a message that an organization doesn't have ability to differentiate between the short term and long term.
    - Sets you off on the wrong foot with the reader of your financials.
- Lenders will want to drill into parent-level analysis when analyzing cash availability.
- Donor restricted – good to know if it is available to support operating activity.

Lender Perspective - Assets

- Gold Star! if your audit notes provide a listing of receivables by broad categorization or specific if significant.
- Other receivables should be presented net of an allowance for doubtful accounts.
  - A management opinion of collectability on receivables can help. You might address that in your liquidity footnote.
- Be prepared to explain any current portion of receivables from affiliates, e.g. development fees.
- Lenders typically combine unrestricted cash with board designated cash because we view both as sources of liquidity that can be tapped to cover obligations.
- Some lenders may drop donor or other restricted cash out of current to non-current unless there is a good description of why it can be tapped in the short term.

Lender Perspective - Assets

Parent Level

- If you have wholly-owned properties, lenders love to see that you have prefunded reserves.
  - Spell this out in the notes.
- Acknowledge that an audit is a point in time.
  - For example, If cash levels are alarmingly low at FYE and A/R is high, work with lender (and possibly auditor) to be able to explain subsequent events such as collection of major receivables.

Current Liabilities

Obligations that are typically due within one year from the balance sheet date:

- Accounts Payable & Accrued Expenses
- Construction Payables – unless they are to be funded with debt or equity
- Current Portion of long term debt – unless it is to be repaid with another long term instrument or equity
- Deferred revenues

Long Term Liabilities

- Permanent financing
- Construction financing & construction payables to be repaid with permanent financing
- Tenant security deposit liability
- Long term accruals for remediation

Classification of Short Term Obligations

Excerpt from the FASB Codification (FASC 470-10-45-14):

- A short-term obligation shall be *excluded* from current liabilities if the entity intends to refinance the obligation on a long-term basis <u>and</u> the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing.

- So you can classify construction loans or construction payables as long-term liabilities if they will be repaid with permanent financing or equity.

Classification of Forgivable Debt

Scenario:

$1,000,000 Loan from the City of Boston forgivable in year 40 as long as certain conditions are met, principally that the property remain affordable and not market rate.

- Many agencies reflect this debt as a long term obligation. You can, however, recognize this loan as revenue as a contribution under the guidance provided by ASC 958 (see Topic 21).

Classification of Forgivable Debt

- Forgivable Debt can be considered a contribution and recorded as revenue if:
  - There is a remote likelihood that loan funds will convert to an unforgivable loan or that the organization will do something in violation of the loan agreement
  - Remote probability is determined by the actual terms of the agreement and the historical performance of the agency under similar circumstances

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Classification of Forgivable Debt

Net Assets:

- The contribution would run through temporarily restricted net assets. The restriction would be released at the same time the payment obligation is released.

- Contributions restricted for the acquisition of long-lived assets can be released from temporarily restricted net assets when the funds are expended for that purpose or over a compliance period associated with the use of those funds.

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Lender Perspective

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- Lenders calculate Liquidity (or Current Ratio) by subtracting Current Liabilities from Current Assets.
- The generally accepted standard is for an organization to show Current Assets over Current Liabilities to be 1.5 or greater.

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Lender Perspective

Solvency and Liquidity measures:

- Unrestricted cash coverage of general operating expenses (# of mos).
  - Typically looking for at least 4 months
- Self sufficiency ratio, what % of your expenses are covered by earned revenues as opposed to grants and contributions.
  - Educate your lender as to the difference between grants and government contracts to make sure they don't leave government contracts out of their self sufficiency analysis.
- Unrestricted cash and current receivables / current liabilities.
  - Want this greater than 1 to show solvency.

Lender Perspective

Forgivable Debt (as opposed to must-pay or cash flow debt)

- Get out ahead of this issue. Know your loan documents and start negotiations with public lenders early.
- Find out who makes the decision(s) and what their process is.
- Sometimes forgiveness can be a big hurdle, and they will push you toward modifications.
- Make the argument that public lenders should be looking at this through a public purpose lens as well as a financial return lens.

- Clear language (especially regarding contingent liabilities associated with public debt that has the potential to be forgiven) can be especially useful with lenders who are less experienced in the affordable housing and community development business.

Lender Perspective

- Clear financial statements often do a better job of explaining an organization's business model than any other document that a lender reviews. As a result, many lenders will look at financials first when they receive a loan application package.

- Lender analysis of financial statements is not rocket science, and most lenders are calculating fairly standard ratios and other metrics in analyzing your organization's financial strength.
  - Strength Matters provides a good insight into lender expectations on the website: **2011 Lender Working Group Survey**. This document includes the most common financial ratios and other underwriting criteria that lenders use. It also provides you a quick sense of the key pieces of information that are being extracted from your financials.

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Liquidity

You will be required to disclose the sources of liquidity available to the organization.

Be certain that discussion has a connection to what is presented in your financials

- e.g. Unrestricted grants receivable totaled $3,500,000 at June 30, 2018, however, all of those receivables were collected by mid August of 2018, resulting in cash on hand that is available to satisfy 40% of operating costs for the year.

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Conclusion

- Assets and liabilities should be classified in a manner that best reflects your organization's liquidity, financial flexibility and the interrelationship of the organization's assets and liabilities.

Goal:

- To present as strong a financial position as possible in a transparent manner for presentation to third parties like lenders and investors.

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